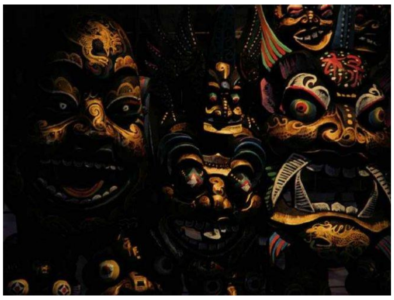
What If China's Economy Lands Hard?

Matthew Boesler and Joe Weisenthal, *Business Insider*, January 18, 2013,

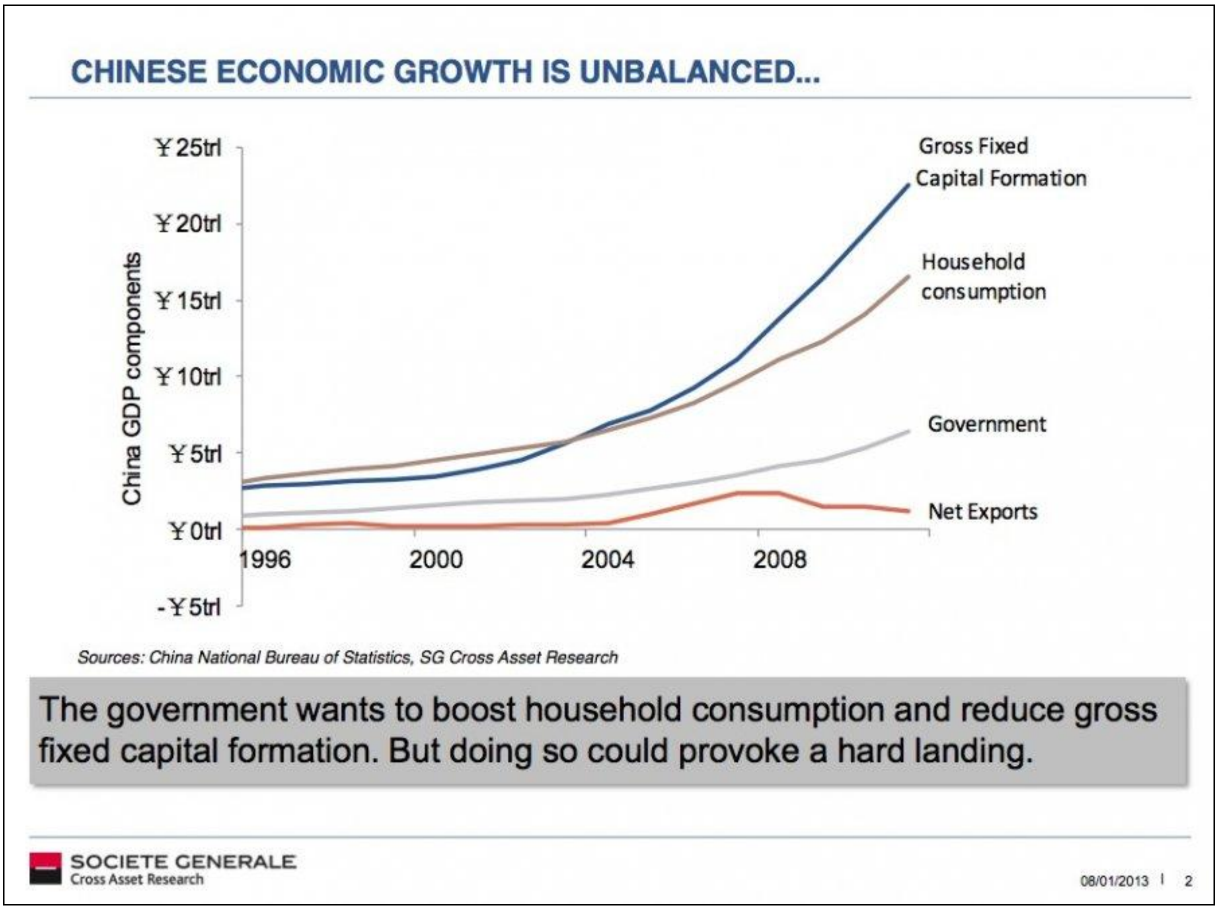


China released Q4 2012 GDP figures last night, and the numbers came in slightly above economists' estimates, re-accelerating to 7.9 percent growth year-over-year from 7.4 percent in the previous quarter. The numbers may distance the Chinese economy from the feared "hard landing scenario" a bit.

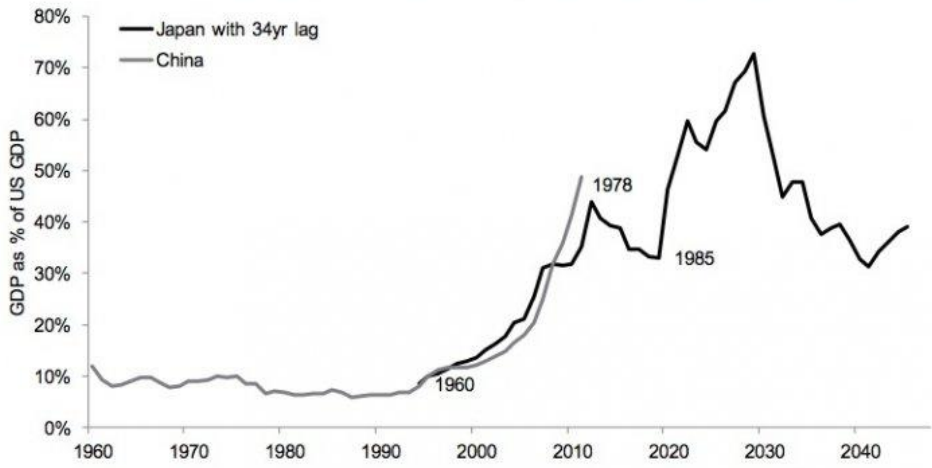
However, China's fate depends very much on that of the global economy over the coming year – and a big shock in one of the world's major economies could revive fears of a hard landing once again. China's fragile shadow banking system is also still a major concern.

Guy Stear and Wei Yao of Société Générale put together an excellent presentation examining how a China hard landing could come about and the impact it would have on a range of asset classes, as well as clients' views on the hard landing scenario.

Thanks to Société Générale for allowing us to feature this presentation.



...AND JAPAN SHOWED THAT TRADE-DRIVEN EXPANSION HAS LIMITS

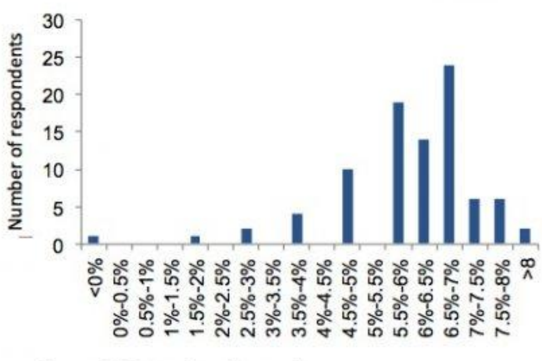


Sources: World Bank, SG Cross Asset Research

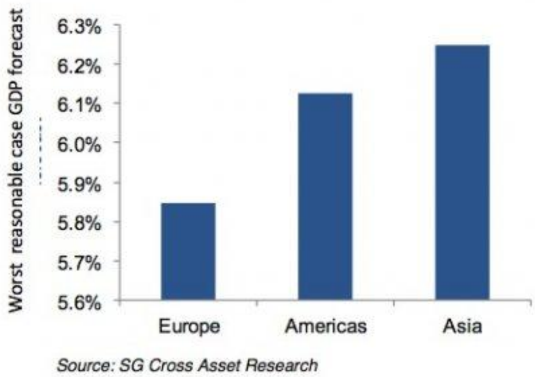
Is China about to take a Japan-style breather?

YET CLIENTS FEEL COMFORTABLE WITH CHINA

In the worst reasonable case, how low do you think Chinese growth will be in 2013?



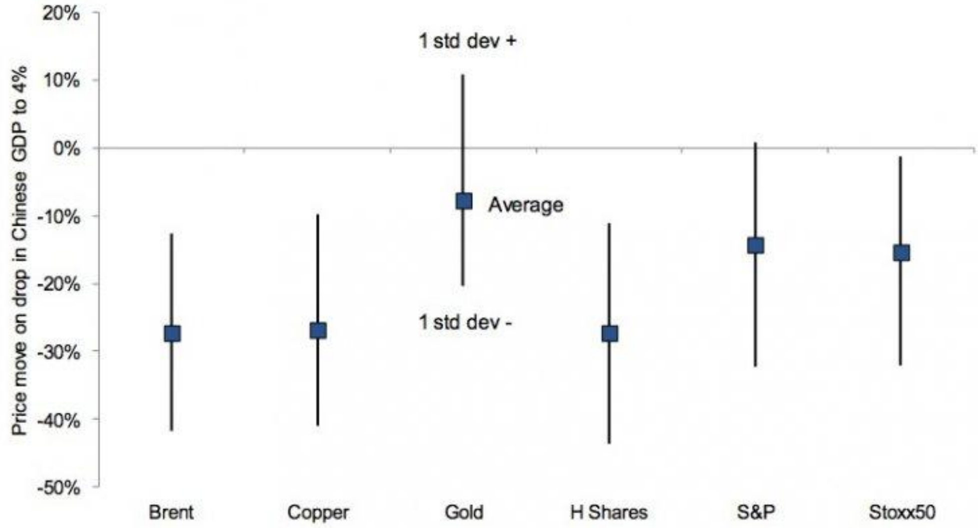
Source: SG Cross Asset Research



Source: SG Cross Asset Research

Almost 2/3rds of investors expect growth of 5.5% to 7% in the worst reasonable case. Europeans are the most pessimistic on China.

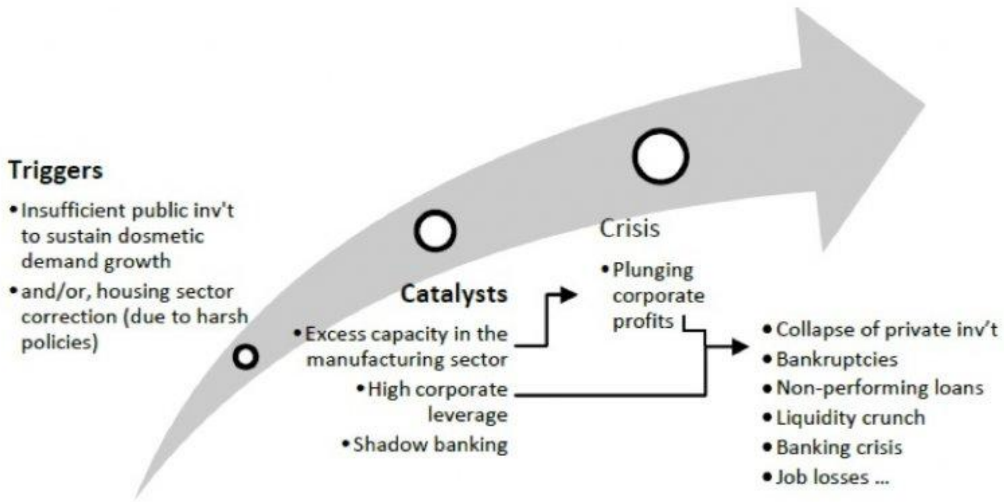
IF CHINESE GROWTH SLIPS TO 4%....



Source: SG Cross Asset Research

The survey average says oil, metals and H shares will fall 25%; US and European equities will drop 15% - and there is a disagreement on gold.

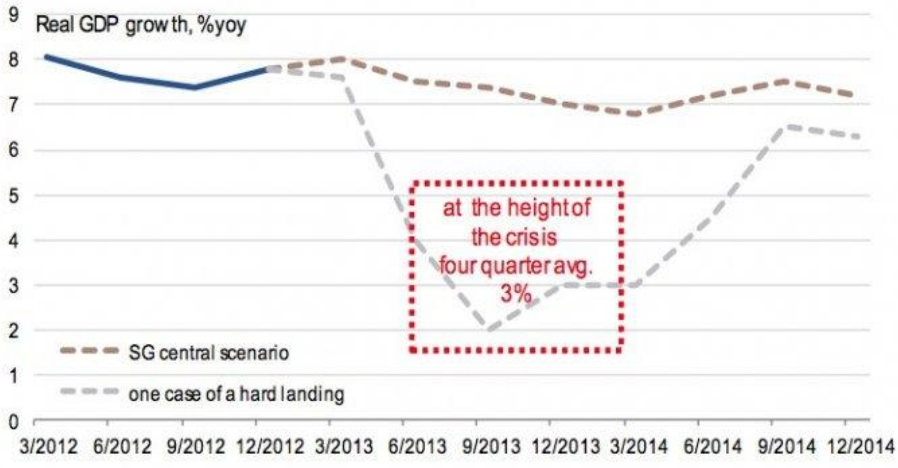
ECONOMICS: HOW COULD IT HAPPEN?



Source: SG Cross Asset Research

A China hard landing would happen in three stages

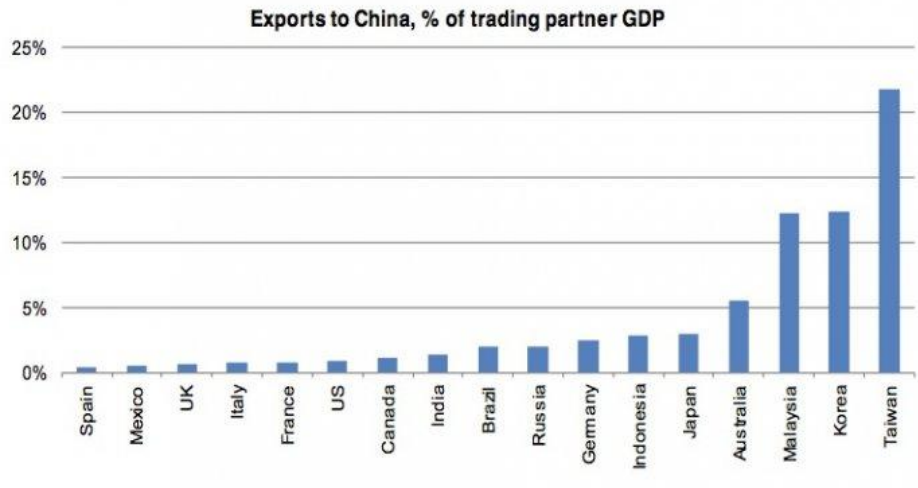
ECONOMICS: HOW BAD COULD IT BE?



Source: SG Cross Asset Research

Since capex is half GDP, a slowdown in capex would cut growth to 4%. As flagging confidence cuts consumption, growth could slump to 3% in the four quarter trough (Q2 13 to Q4 14).

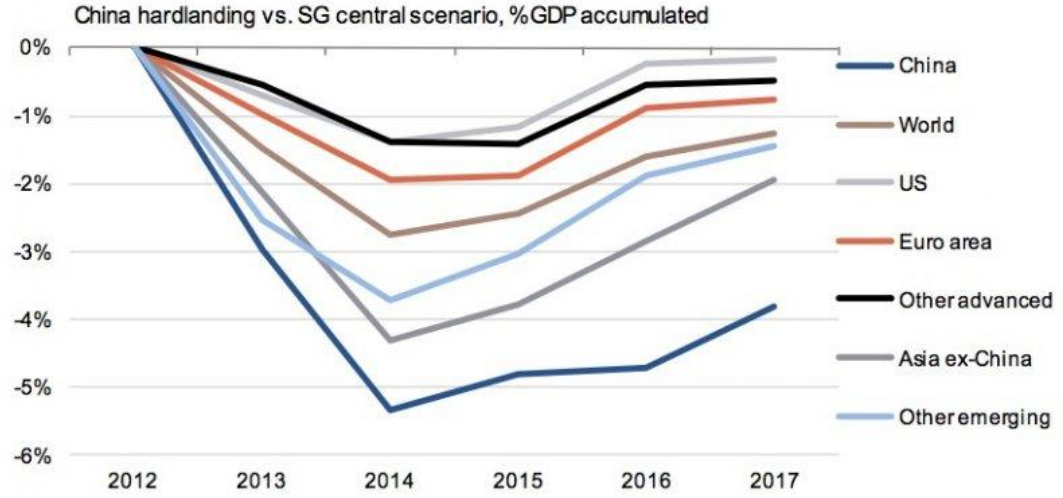
ECONOMICS: WHICH OTHER COUNTRIES WOULD SUFFER?



Sources: IMF, OECD, SG Cross Asset Research

Exports to China represent the highest percentage of GDP in Asian countries. Taiwan is the biggest exporter of consumer and capital goods.

ECONOMICS: WHICH OTHER COUNTRIES WOULD SUFFER?

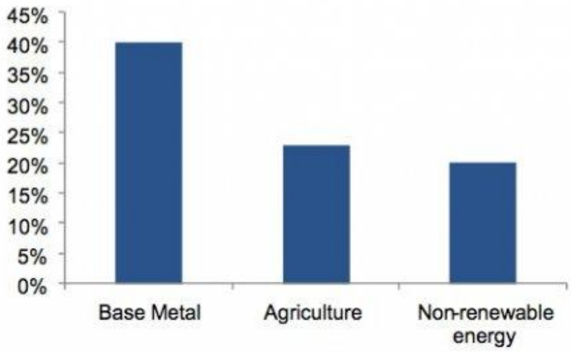


Sources: IMF, Datastream, SG Cross Asset Research

The US would suffer the smallest effect from a Chinese hard landing, while the eurozone would be more seriously affected.

COMMODITIES: COSTS PROVIDE A LONG-TERM FLOOR FOR PRICES

China as % of world demand



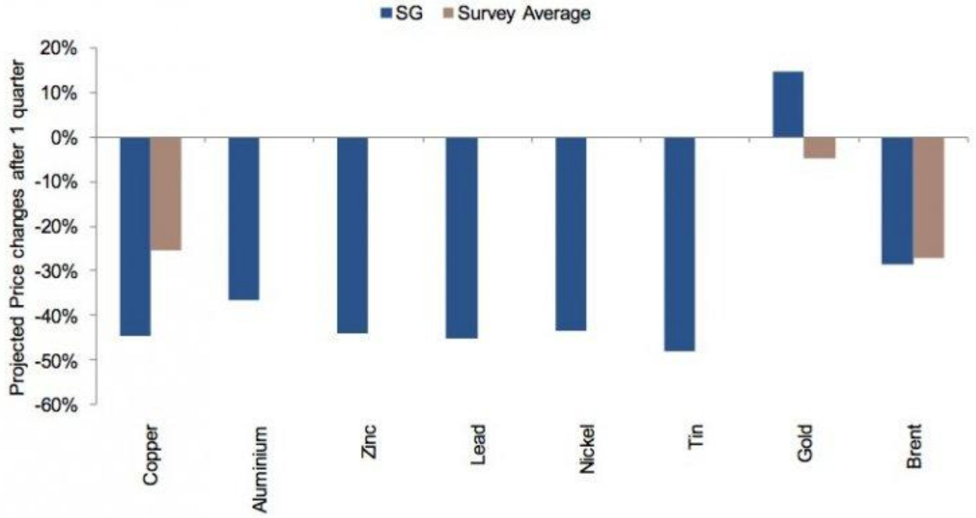
Source: IMF

Production cost as % of current price

Sources: SG Cross Asset Research, Bloomberg

While China is a dominant source of demand, prices of some products have already fallen below their extraction costs. This is an issue for metals, where operating costs are much higher than fixed costs.

COMMODITIES: INVESTORS TOO BULLISH ON METALS, TOO BEARISH ON GOLD

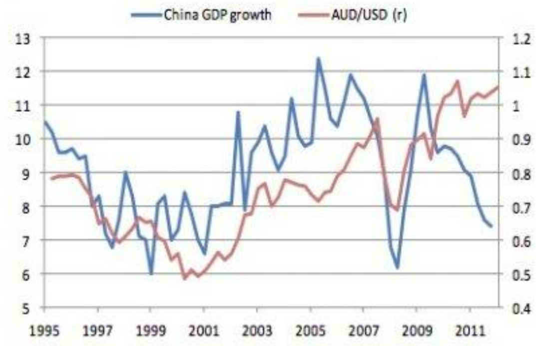


Sources: SG Cross Asset Research

Our commodity analysts believe metals prices could drop 45% - much more than the survey suggests. Gold would rally, however.

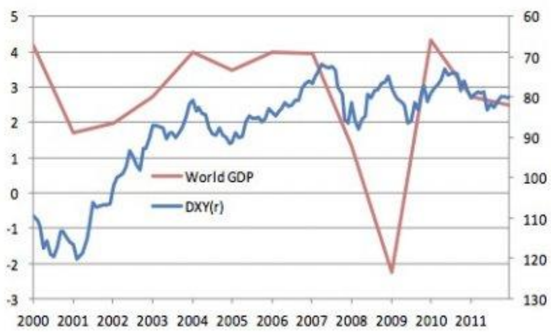
FX: DOLLAR TO BENEFIT FROM A FLIGHT TO QUALITY

Australian dollar follows China



Sources: National Statistics Bureau of China, Bloomberg

Dollar follows world growth

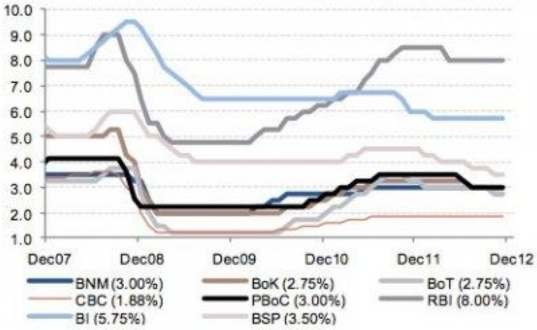


Sources: World Bank, Bloomberg

The dollar should be the big beneficiary from both a flight to quality and a deceleration in global growth. We expect average gains on 10%, and more against Asian currencies such as the AUD

ASIAN RATES AND FX: LOWER SHORT RATES, STEEPER CURVES

Short rates back to 2009 levels



Sources: Bloomberg

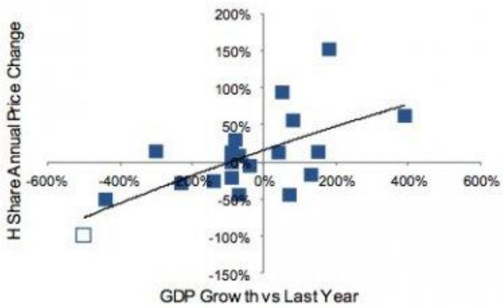
And steeper curves in the front end

Sources: Bloomberg, SG Cross Asset Research

Investors should set up receivers in the 2yr area of China, and receive 2yr vs 5yr duration-weighted across the region.

ASIAN EQUITY: TWO MODELS TO FORECAST PRICES

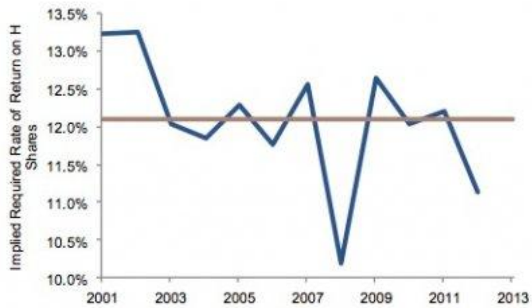
Regress against GDP



Sources: National Statistics Office, Hang Seng, SG Cross Asset Research

Chinese stock returns are positively correlated with the one-year change in GDP growth. A sharp drop implies weaker stocks.

Or look at dividends

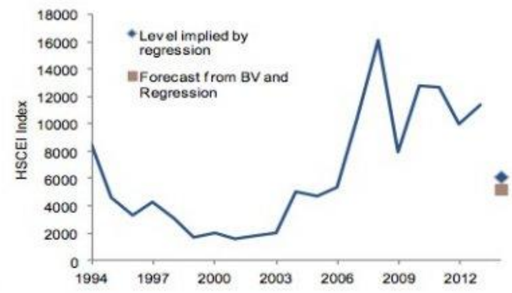


Sources: Hang Seng, Bloomberg, SG Cross Asset Research

We can also use a discounted dividend model, taking the average 12% implied required return since 2001, and including a drop in dividends.

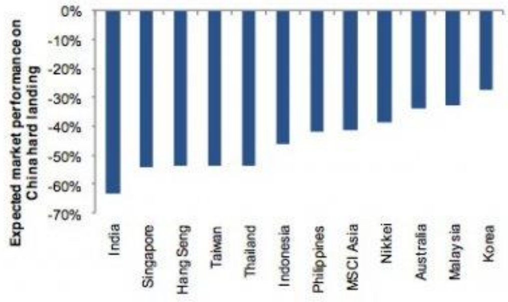
ASIAN EQUITY: A 50% DROP IN H SHARES IS POSSIBLE

A drop of 40-55% in H shares



Sources: National Statistics Office, Hang Seng, SG Cross Asset Research

And most other Asian markets fall too



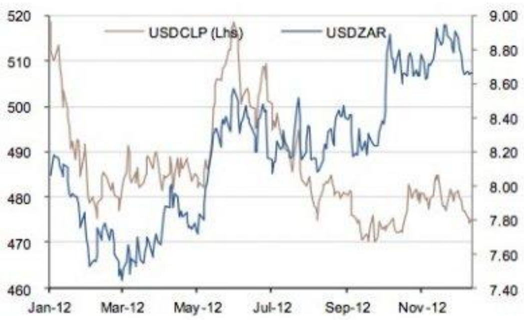
Sources: Hang Seng, Bloomberg, SG Cross Asset Research

Using the two models suggests the H shares could drop back to the levels of 2006. This would be as bad as the 1994-2000 percentage drop.

All other Asian markets would fall in the wake of China, though the big cap markets should do better than Asean.

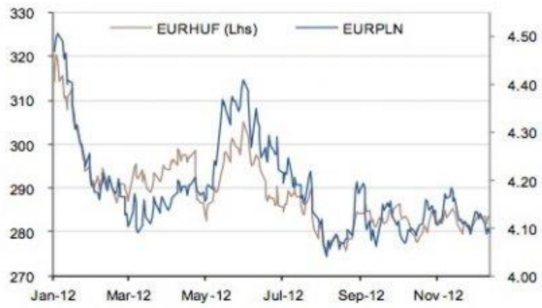
EMERGING MARKETS: MOST EM CURRENCIES TO SLIDE

Rand & Chilean Peso to slide



Sources: Bloomberg, SG Cross Asset Research

Zloty and Forint would also slide



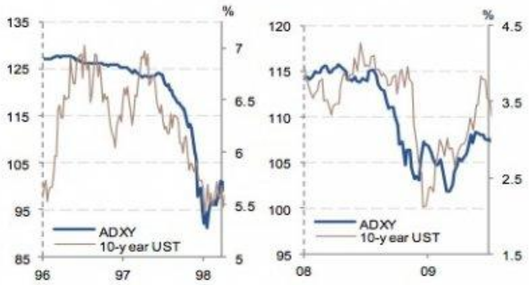
Sources: Bloomberg, SG Cross Asset Research

The ZAR and the CLP are the two currencies most sensitive to global growth shocks.

But eastern European currencies such as the PLN and HUF would also be affected

GLOBAL RATES: TREASURIES TO BENEFIT

1998 and 2008/9 show a flight to quality



Sources: Bloomberg, SG Cross Asset Research

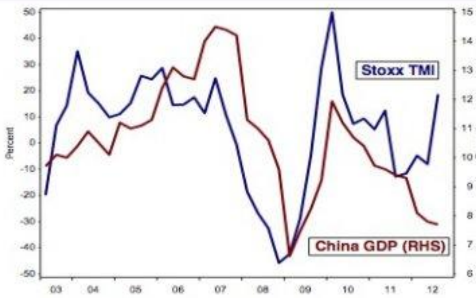
Treasury purchases reflect trade flows

Sources: TICS report

The flight to quality would benefit treasuries, just as it did in 1998 and in 2008/9. Purchases of treasuries are used to balance trade flows, so a USD debt strike would be counterproductive for Chinese exports.

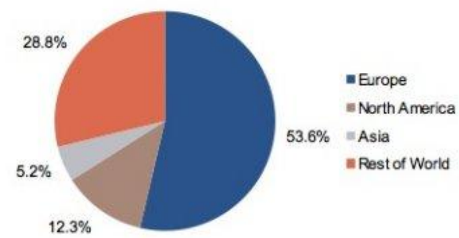
EUROPEAN EQUITY: MORE OF A SECTOR PLAY

Will European stocks follow Chinese GDP this time?



Sources: Stoxx, Reuters Ecowin, SG Cross Asset Research

European companies sell little in Asia

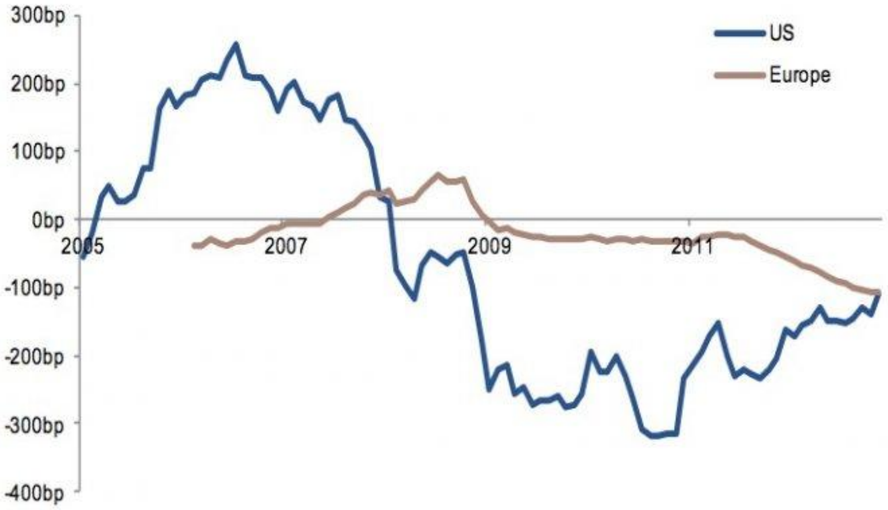


Sources: Reuters Ecowin, Factset ,SG Cross Asset Research

Fear of contagion and rising risk premia might drive European stocks 20% lower, but trade flows would not. Buy media and food retailers, and sell resource stocks, tech-hardware and banks.

GLOBAL CREDIT: LOW YIELDS TO BOOST THE TECHNICAL BID

Our shortfall model shows that yield based investors still need the extra yield that credit provides. If bond yields drop, the problem will get worse.



Sources: SG Cross Asset Research

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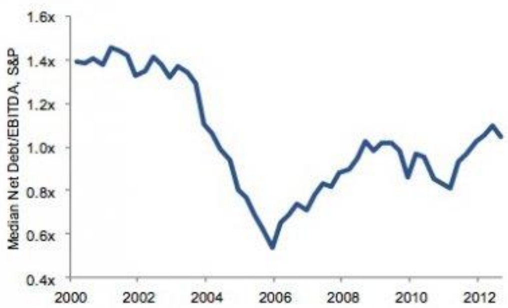
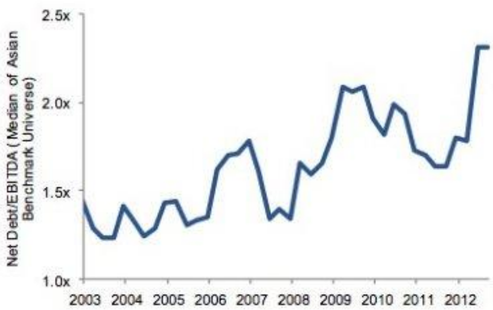
GLOBAL CREDIT: BUY EUROPE & THE US VS ASIA

Leverage still low in the US



Sources: Bloomberg, S&P, SG Cross Asset Research

But has increased in Asia



Sources: Bloomberg, SG Cross Asset Research

Asian credits face two problems:
• Operating cash flow will decline as growth slows.
• Leverage has already increased.

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